African countries aren't getting as much as they should from foreign direct investment

By Muazu Ibrahim

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Economic growth is driven by a number of factors. These include foreign direct investment, national savings, household spending, fiscal and monetary policies. Since the late 1980s African governments have fully embraced foreign direct investment as a major driver of growth.

There has been a slide in the levels of foreign direct investment in Africa. Wikimedia Commons

One of the avenues through which countries have sought to attract more foreign direct investment has been investment summits. These are hosted jointly with developed countries. They include the Africa-China Investment Summit, Africa-UK Investment Summit and the Africa-US Investment Summit.

Despite these efforts, data shows that Africa has not been a major recipient of these flows. In fact, it attracts a lot less than other developing countries.

There's a bigger problem too – the impact on economic growth of the foreign direct investment the continent attracts is lower than other comparable parts of the world. In our research we set out to understand why. To do this, we looked at the financial services sector which is underdeveloped in most African countries.

The search

We examined data from 45 countries between 1980 and 2016. The variables we looked at included economic growth, foreign direct investment, financial sector development, human capital, government expenditure and gross fixed capital formation.

The countries were selected based on data availability. They comprised several countries from all the regional blocs, including six countries from Northern Africa.

Overall, the countinent's financial sector is under-developed compared to other emerging economies, with the exception of South Africa which is relatively well-developed. The countries' financial sectors are bank-based, thus providing limited space for the equity (capital) markets.

We sought to examine the relationship among three factors: foreign direct investment, economic growth, and financial sector development. Financial sector development measures a country's financial institutions to make financial services available to citizens. It also includes the provision of finance to businesses.

There has been a lot of economic literature on the impact of foreign direct investment on economic growth. And there have been many studies on the linkages between foreign direct investment, financial sectors and economic growth. But less has been done on the extent to which Africa's financial sector is a conduit through which foreign direct investment drives economic growth.

Research findings on the impact of foreign direct investment on a country's economic growth are mixed. This implies that the extent of the impact is determined by other factors and characteristics of a country's economy.

That's why we chose to look at how the financial sector, in particular its stage of development, can moderate the impact of foreign direct investment on economic growth.

What attracts foreign direct investment

For the most part, foreign direct investment inflows to Africa have generally been attributed to five factors. These are regulations (ease of doing business), the general investment climate, broader economic reforms, information communication and technology development, and improvements in infrastructure.

Foreign direct investment plays an important role in economic development. It provides financial resources, technological spillovers and improvement in human capital. These are all critical factors that can spur Africa's economic development by addressing infrastructural deficits and reducing unemployment.

The effect of foreign direct investment on economic growth is well documented globally. Funds from foreign investors are channelled through a country's financial system before being allocated to the targeted beneficiary of the investment.

In Africa's case we found that the continent's underdeveloped financial sector has dampened the impact of foreign direct investment on economic growth.

To measure financial sector development we calculated credit provided by the financial sector to the private sector as a percentage of GDP. On this measure, Africa's financial sector fails to allocate financial resources effectively and efficiently to the productive sectors of the economy.

When the financial sector does allocate resources, it invests in risky projects. The net effect is that it hurts economic growth and therefore fails to support foreign direct investment.

What's to be done

Foreign direct investment inflows to Africa are increasing, albeit marginally. What our study shows is that African governments need to spend more effort on maximising the impact of foreign direct investment on economic growth. This is over and above current efforts to gain a bigger share of global foreign direct investment flows. Failure to raise the impact of foreign direct investment on economic growth will mean that African countries will not fully benefit from higher inflows.

Improving the performance of the financial sector should be one of the major preoccupations of African policymakers. This should include regulators improving their supervisory roles. And they should strengthen the financial sector's ability to allocate resources effectively to the productive sectors of the economy. Improvements in corporate governance and risk management strategies would also help.

This article was co-authored with Abraham Mensah Acquah. He holds BA (Integrated Business Studies) and a Master of Commerce degree in Banking and Finance from the School of Business and Law, University for Development Studies, Wa, Ghana.

ABOUT THE AUTHOR

Muazu Ibrahim, Lecturer, Department of Banking and Finance, *University for Development Studies*